Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:POSTF-112147-02
EYWu

date: APR 1 2 2002

to: Ethelyn McDaniel, Case Manager (LMSB 1755)
Ron Hojo, Revenue Agent

from: June Y. Bass, Associate Area Counsel (LMSB)
Erica Y. Wu, Attorney (LMSB)

subject: Taxpayer: ███████████████ Inc.
Tax Year: ██████
Issue: Accrued Accounting Fees - All Events Test

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized
disclosure of this writing may have an adverse effect on privileges,
such as the attorney client privilege. If disclosure becomes necessary,
please contact this office for our views.

This memorandum responds to your request for our advice dated March 1, 2002.
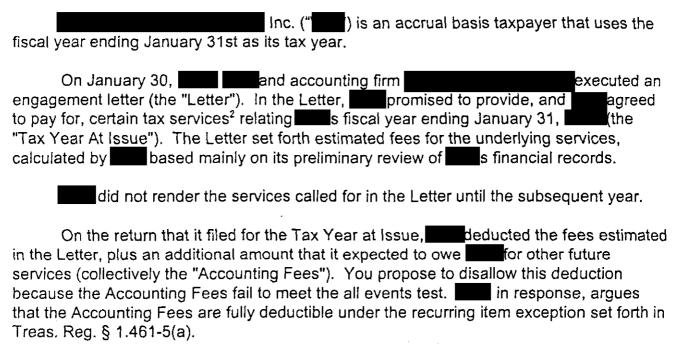This memorandum should not be cited as precedent.

ISSUE

For the fiscal year ending January 31, ████ whether the Taxpayer may deduct
estimated costs for accounting services that were not rendered until a later period.

CONCLUSION

No. The Taxpayer may not take the deduction because the all events test with
respect to the estimated costs has not been satisfied.

20159

FACTS[1]

████████████████████████ Inc. ("███") is an accrual basis taxpayer that uses the fiscal year ending January 31st as its tax year.

On January 30, ███ ███ and accounting firm ████████████████████ executed an engagement letter (the "Letter"). In the Letter, ███ promised to provide, and ███ agreed to pay for, certain tax services[2] relating ███ s fiscal year ending January 31, ███ (the "Tax Year At Issue"). The Letter set forth estimated fees for the underlying services, calculated by ███ based mainly on its preliminary review of ███ s financial records.

███ did not render the services called for in the Letter until the subsequent year.

On the return that it filed for the Tax Year at Issue, ███ deducted the fees estimated in the Letter, plus an additional amount that it expected to owe ███ for other future services (collectively the "Accounting Fees"). You propose to disallow this deduction because the Accounting Fees fail to meet the all events test. ███ in response, argues that the Accounting Fees are fully deductible under the recurring item exception set forth in Treas. Reg. § 1.461-5(a).

DISCUSSION

I.   Applicable Law.

I.R.C. § 461 governs the determination of when a liability is incurred and taken into account for Federal income tax purposes. For accrual method taxpayers, a liability is incurred and taken into account in the year in which (1) all events have occurred that establish the fact of liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2). The first two prongs are commonly known as the "all events test."

---

[1]   Our understanding of the facts of this case is limited to the facts presented by you. We have not undertaken any independent investigation of the facts of this case. If the actual facts are different from the facts known to us, our legal analysis and our conclusions and recommendations might be different. Accordingly, if you learn that the facts known to us are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

[2]   ███ was to audit ███ s financial statements and prepare all required tax returns for the fiscal year ending January 31, ███

The all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability. Treas. Reg. § 1.461-4(a). If the liability arises out of the provision of services to the taxpayer by another person, economic performance occurs as such person provides such services unless the recurring item exception under Treas. Reg. § 1.461-5(a) applies.[3] Treas. Reg. §§ 1.461-4(d)(2), 1.461-5(a). The recurring item exception is strictly an exception to the economic performance rules; it is not an exception to the all events test.
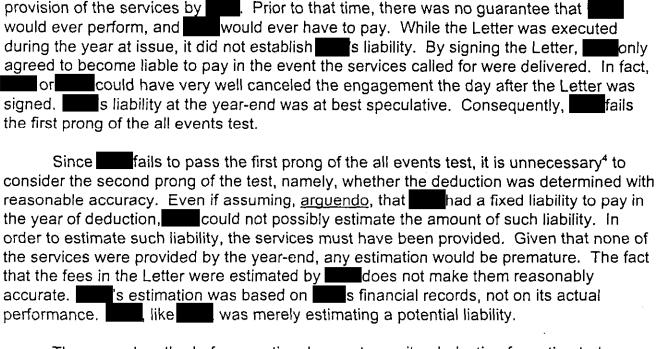
II.   Analysis

In this case, ███ is essentially seeking to deduct estimated future expenses. ███ relies solely on the recurring item exception to counter your all events test argument. ███ appears to be merging the all events test with the economic performance requirement as one single test, and arguing that if the recurring item exception applies, it needs not meet the all events test. This rationale is incorrect. The recurring item exception does not entitle a taxpayer to bypass the all events test. To the contrary, and as Treas. Reg. § 1.461-5(b) clearly shows, meeting the all events test is a prerequisite to the recurring item exception. Therefore, before we consider the applicability of the recurring item exception, we must determine whether the all events test has been met.

The first prong of the all events test requires that the taxpayer's liability be fixed in the year of deduction. The purpose of this requirement is to ensure that a taxpayer will not take deductions for expenditures that might never occur. Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 410 (5th Cir. 1969). The United States Supreme Court has long held that a liability is not fixed as long as it remains contingent. Brown v. Helvering, 291 U.S. 193, 200 (1934). Where, as here, a taxpayer's liability stems from a promise to pay in exchange for future services, the liability is not fixed until the services are rendered. See Levin v. Commissioner, 21 T.C. 996 (1954), aff'd 219 F.2d 588 (3rd Cir. 1955); Amalgamated Housing Corp. v. Commissioner, 37 B.T.A. 817 (1938), aff'd per curiam, 108 F.2d 1010 (2d Cir. 1940).

Applying the foregoing principles, it is clear that ███s liability did not become fixed in the year of deduction. In this case, the last event necessary to fix ███s liability was the

---

[3] Under the recurring item exception, a liability is treated as incurred for a taxable year if (i) as of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonably accuracy; (ii) economic performance with respect to the liability occurs on or before the earlier of (A) the date the taxpayer files a timely return; or (B) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature and (iv) either (A) the amount of the liability is not material; or (B) the accrual of the liability for that taxable year results in a better match with the income that would result from accruing the liability for the taxable year in which economic performance occurs. See Treas. Reg. § 1.461-5(b).

provision of the services by ███. Prior to that time, there was no guarantee that ███ would ever perform, and ███ would ever have to pay. While the Letter was executed during the year at issue, it did not establish ███'s liability. By signing the Letter, ███ only agreed to become liable to pay in the event the services called for were delivered. In fact, ███ or ███ could have very well canceled the engagement the day after the Letter was signed. ███s liability at the year-end was at best speculative. Consequently, ███ fails the first prong of the all events test.

Since ███ fails to pass the first prong of the all events test, it is unnecessary[4] to consider the second prong of the test, namely, whether the deduction was determined with reasonable accuracy. Even if assuming, arguendo, that ███ had a fixed liability to pay in the year of deduction, ███ could not possibly estimate the amount of such liability. In order to estimate such liability, the services must have been provided. Given that none of the services were provided by the year-end, any estimation would be premature. The fact that the fees in the Letter were estimated by ███ does not make them reasonably accurate. ███'s estimation was based on ███s financial records, not on its actual performance. ███, like ███ was merely estimating a potential liability.

The accrual method of accounting does not permit a deduction for estimated anticipated expenses if it is based on events that have not occurred by the close of the taxable year. United States v. General Dynamics Corp., 481 U.S. 239, 243-44 (1987). We therefore concur with your determination to disallow ███'s deduction for the Accounting Fees. Further, since ███ has failed to meet the all events test, the recurring item exception does not apply.

This advice will be forwarded to the National Office for post-review. If you have any questions, please contact Erica Wu at (949) 360-2678.

---

[4]   To pass the all events test, each prong of the test must be independently satisfied.